1991

State and local governmental developments - 1991; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

State and Local Governmental Developments—1991

Update to the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*

Includes *Audit Risk Alert—1990*

Issued by the Auditing Standards Division

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This document, which contains *State and Local Governmental Developments—1991* and *Audit Risk Alert—1990*, is intended to provide auditors of financial statements of state and local governmental units with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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1 2 3 4 5 6 7 8 9 0 AudS 9 9 8 7 6 5 4 3 2 1

Table of Contents

State and Local Governmental Developments—1991

Economic and Industry Conditions

The current economic downturn is affecting governments in many ways. Declining tax bases cause property tax revenues to fall below budgeted levels, decreases in consumer spending are reflected in declining sales tax revenues, and higher unemployment figures translate into lower income tax revenues. Even though revenues are declining, expenditures are not. In fact, in many cases, expenditures are increasing and governments are feeling more and more pressure to balance their budgets. As a result, many are considering "one-shot adjustments" such as—

- Delaying payment of employee salaries or benefits to reduce expenditures reported in cash-based budgets.
- Making transfers to the general fund from other funds, to decrease the budgeted and GAAP-based deficit of the general fund without improving the financial condition of the government.
- Selling assets, restructuring debt, reducing scheduled contributions to pension funds, and deferring scheduled maintenance, all of which can give the appearance of improving the government's current financial position.

When such measures are taken, auditors should consider whether any existing legal or contractual requirements have been violated and whether adequate disclosure has been made in the financial statements.

The Political Environment

Because governments operate in a politically sensitive environment, the potential impact of mismanagement, defalcations, and noncompliance with laws and regulations may be the focus of a greater amount of attention in government than in other environments. Many governments have adopted legislation on financial accountability and internal controls because of the increased public focus on the fiscal accountability of elected officials and government employees. Such legislation often includes—

- Guidelines on conflicts of interest and ethics.
- Requirements for competitive bidding for purchases of goods or services.
- Restrictions on the use of discretionary funds.
- Restrictions on travel and entertainment expenses.
- Restrictions on private use of publicly owned property (for example, automobiles).
- Restrictions on outside political activities.
- Restrictions on lobbying.
- Tax reporting requirements (for example, 1099s and arbitrage interest rebates).
- Guidelines governing investment policies.
- Requirements to implement controls to prevent budgets from being exceeded or amended.

The Audit Environment

Audit quality and high-risk federal financial assistance programs are still of great concern, as shown by the lack of improvement in the audit quality statistics issued by the Standards Subcommittee of the President's Council on Integrity and Efficiency (PCIE).

In recent semiannual reports of the PCIE Standards Subcommittee on the quality of nonfederal audits reviewed by the Federal Inspectors General (IGs), the IGs have cited significant reporting and auditing deficiencies that have caused audit reports to be rejected. The deficiencies included—

- Missing reports on internal controls, compliance, or both.
- Missing financial statements, including note disclosures or required supplementary data.
- Inadequate workpaper documentation of the procedures performed in reviewing the internal control structure or in testing for compliance with applicable laws and regulations.
- Missing comments by the auditor on the status of prior-period audit findings.
- Deficient reporting language.

Auditors who issue deficient audit reports or perform inadequate procedures may be subject to remedial or corrective action, including suspension from performing further audits of recipients of federal funds.

The U.S. Department of Education and the PCIE are making efforts to improve the quality of audits. The Education Department's Office of Inspector General (ED-OIG) is conducting free one-day and half-day seminars on the March 1990 revision of its audit guide for student financial assistance programs in selected regional cities. Dates and locations of the seminars can be obtained by contacting the ED-OIG at (202) 732-4798. The PCIE has issued a set of revised checklists for desk and quality control reviews conducted by department and agency IGs of single audit reports and auditors' workpapers. The revisions will bring the checklists up to date with respect to new audit standards and changes to other guidance. They can be obtained by contacting the PCIE at the address listed in the "References for Additional Guidance" section of this alert.

Specific Conditions or Risk Factors

The following conditions may indicate (but do not necessarily confirm) the existence of increased audit risk. The listing of factors is not all-inclusive.

Higher-Risk Federal Programs. As noted in last year's audit risk alert, certain federal grant programs subject to single audit coverage continue to be considered to have a higher-than-normal risk of fraud and abuse. Such programs may involve increased audit risks. These programs include—

- The Food Stamp program.
- HUD Mortgage programs.
- Job Training Partnership Act programs.
- Mass transit grants.
- Discretionary grants awarded by the U.S. Department of Education.
- The Environmental Protection Agency (EPA) Superfund program.

The Commerce Department's Minority Business Development Agency programs, the Small Business Administration's Small Business Development Centers programs, and the Department of the Interior's Bureau of Territorial and International Affairs programs have recently joined the list of higher-risk programs.

The following criteria indicate that a federal program may be vulnerable to mismanagement:

- Economic conditions, such as the collectibility of taxes and allowances or reserves for collectibility of taxes
- Broad, inadequately supervised delegation of authority

- Excessively decentralized program execution, including use of subrecipients
- Potential for physical or environmental damage
- Recent start-up or pending termination
- Inadequate attention to management by political leadership

Complex Laws and Regulations. Due to the myriad of complex laws and regulations that apply to state and local governments, the risk of noncompliance is increased. Areas of noncompliance may include, for example, collateralization requirements for deposits and investments; investment restrictions; arbitrage regulations and rebate rules; and withholding, reporting, and remitting of payroll taxes. SAS No. 54, *Illegal Acts by Clients,* requires that audits be designed to detect noncompliance with those laws and regulations that have a direct and material effect on the determination of financial statement amounts. In order to meet that requirement, auditors should assess whether management has identified laws and regulations that have a direct and material effect on the determination of amounts in the governmental entity's financial statements.

Deposits and Investing Activities. The following factors relating to deposits and investments may increase audit risk:

- Undocumented, unapproved, or inadequate investment policies, procedures, and controls
- Lack of required collateral, or insufficient collateral based on current market values, for uninsured deposits
- Certain investments and investing activities, such as repurchase and reverse repurchase agreements, margin accounts, venture capital, securities with maturities that exceed the period in which the funds will be required to meet short-term cash needs, securities with high rates of return and corresponding high market risk, and trading and "churning"

GASB Statement No. 3, *Deposits With Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements,* provides guidance on disclosure of deposits and investment activities of governmental entities.

Revenue Bond Defaults. Falling property values, shortfalls in expected revenues from tax-increment financing (TIF), and slower and smaller revenue streams to service TIF debt all contribute to the possibility that violations of bond covenants may occur. Auditors should inquire about whether debt issuance limitations have been exceeded and about whether any events of default or violations of debt covenants may have occurred. If such events or violations have occurred, auditors should consider whether adequate disclosure has been made in the financial statements.

Self-Insurance Arrangements and Incurred-but-Not-Reported (IBNR) Claims. Self-insurance or pool insurance arrangements have become increasingly popular as a result of increases in premiums charged by insurance companies. These arrangements typically cover employee medical, workers' compensation, vehicle collision, general liability, and property insurance. Government funding of many of these risks is often determined based on available resources rather than on sound actuarial methodologies and assumptions. In such cases, a government may have inadequate reserves to cover losses.

Furthermore, improper accounting for incurred-but-not-reported (IBNR) claims may result in underreporting of liabilities and inadequate disclosures.

Guidance on accounting and reporting self-insurance activities and IBNR claims can be found in chapter 10 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units.* GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues,* is not yet effective for entities other than public entity risk pools.

Auditors should call their clients' attention to possible problems, such as inadequate loss experience data, that may arise when GASB Statement No. 10 is initially implemented. The statement's requirements affecting public entity risk pools are effective for financial statements for periods beginning after June 15, 1990.

Regulatory and Legislative Update

The following regulatory and legislative developments may be relevant to audits of state and local governments.

Revised Compliance Supplement for Single Audits

The revised U.S. Office of Management and Budget (OMB) *Compliance Supplement for Single Audits of State and Local Governments,* issued in September 1990, added three new general requirements (that is, drug-free workplace, administrative requirements, and allowable costs/cost principles) and updated the specific requirements and related audit procedures applicable to federal programs. The extensive audit procedures added for the new allowable costs/cost principles requirement reflect current government sensitivity to alleged deficiencies and abuses in this area.

Indirect Overhead Billed to Federal Agencies

Several federal agencies have announced that they are conducting inquiries of universities that are among the largest recipients of federal research grants. Federal research grants generally represent reimbursement for direct costs related to research projects and indirect costs representing overhead items not directly related to projects. The inquiries are focusing on the nature of the costs billed to the agencies in conjunction with research conducted by the institutions. Auditors should be mindful of the growing concern that indirect cost pools may include costs that might eventually be disallowed.

Hawkins-Stafford Act

The Augustus F. Hawkins—Robert T. Stafford Elementary and Secondary School Improvement Amendments of 1988 (P.L. 100-297) could have a major impact on the Inspector General's reviews of audit reports of colleges and universities that qualify for coverage under the Single Audit Act. Key provisions of the amended law change the nature of the U.S. Department of Education's policies on disallowances taken as the result of audit findings.

Under the revised statute and regulations, when a Department of Education official decides that a grant recipient must return grant funds because of a violation of law or regulation, the official is required to send a written notice of the disallowance decision. The notice must provide a *prima facie* case for the recovery of funds and include "a statement of the law and the facts that, unless rebutted, is sufficient to sustain the conclusion drawn in the notice." The regulations state further that a prima facie case can be established if a recipient failed to maintain records required by law or failed to provide an authorized representative of the Secretary of Education with access to them.

Auditing Federal Financial Assistance

Depending on the amount and source of federal financial assistance it receives, a governmental entity may be required to satisfy audit and reporting requirements described in *Government Auditing Standards* (1988 revision), the Single Audit Act of 1984, other federal agency policies and regulations, and agreements or contracts with federal agencies.

Federal IGs are required by law to ensure that audit work conducted by nonfederal auditors of government organizations, programs, activities, and functions complies with government auditing standards as set forth in *Government Auditing Standards,* issued by the Comptroller General of the United States. These standards include requirements for reporting on financial related audits, compliance with laws and regulations, and internal controls. Nonfederal auditors are required to follow these standards when they assert that their audits are conducted in accordance with *Government Auditing Standards.*

The Single Audit Act of 1984 requires each state and local government that receives a total amount of federal financial assistance equal to or in excess of $100,000 in any fiscal year to have an audit made for that year in accordance with its requirements. Governments that provide federal grant funds to other organizations through a subgrant relationship are required to ensure that the subrecipient organization complies with the applicable federal audit requirements.

Continuing Professional Education Requirements

Government Auditing Standards requires auditors responsible for planning, directing, conducting, or reporting on government audits to complete eighty hours of continuing professional education (CPE) every two years, with at least twenty to be completed each year. The first two-year period ended on December 31, 1990. Since state CPE requirements are frequently on a different time frame, this increases the amount of record keeping required.

Of these eighty hours, at least twenty-four should be in subjects directly related to the government environment and to government auditing. The twenty-four-hour requirement applies to those planning, directing, reporting, and conducting *substantial portions of fieldwork.* Several issues relating to compliance with these requirements are addressed in a U.S. General Accounting Office (GAO) staff interpretation of the CPE requirements issued in April 1991. Questions addressed in the interpretation focus on the following:

- Who is subject to the CPE requirements?
- When should compliance with CPE requirements be determined?
- What qualifies as acceptable CPE?
- How are CPE requirements to be administered?

Copies of the interpretation can be purchased from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20401. The stock number of the document is 020-000-00250-6.

The AICPA offers several courses that meet these CPE requirements. These courses are listed in the "References for Additional Guidance" section of this alert.

Peer Review Requirements

Government Auditing Standards requires audit organizations to participate in an external quality control review at least once every three years and establish an internal quality control system. Audit organizations that perform audits in accordance with *Government Auditing Standards* after January 1, 1989, must undergo this external quality control review by January 1, 1992.

Other Audit Requirements

Other federal policies and regulations (such as OMB circulars and related compliance supplements) and federal department audit guides or handbooks may contain applicable audit requirements. OMB compliance supplements are intended to provide uniform audit and reporting requirements among the federal agencies and departments. Auditors need to determine whether there are audit guide requirements in addition to those contained in the OMB compliance supplements.

Agreements or contracts between an entity and a federal department or agency may specify additional audit requirements.

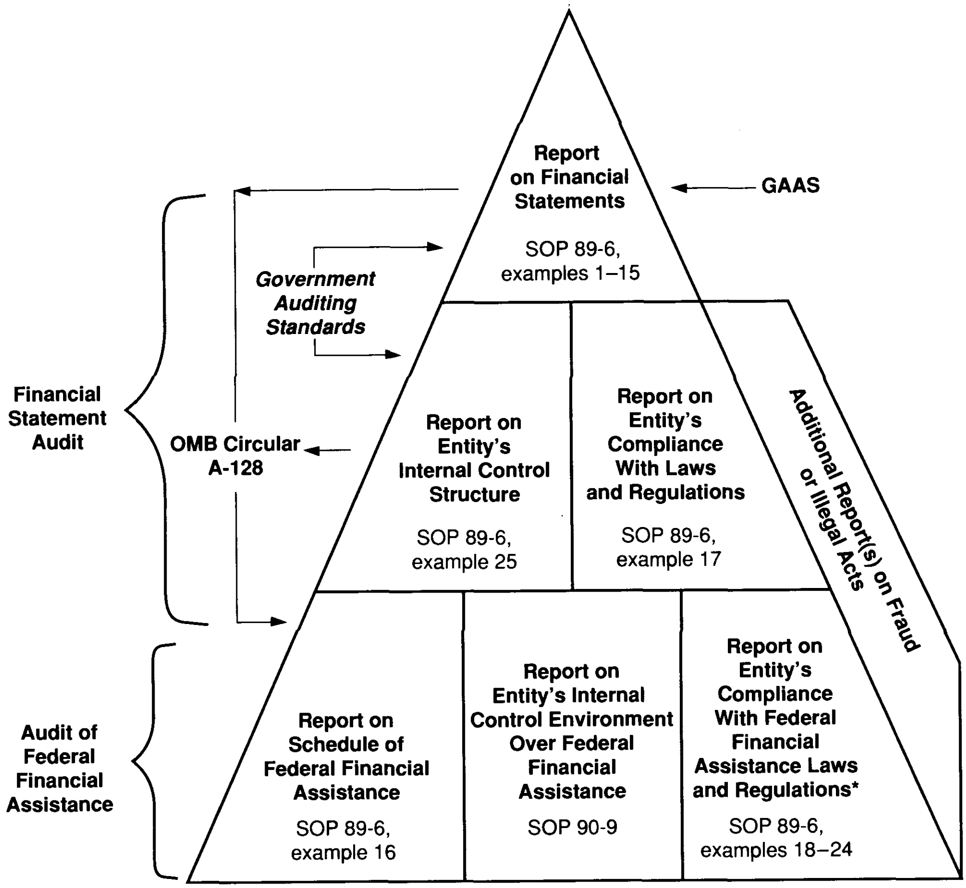
Single Audit Reporting Issues

Single audit reporting issues continually arise as a result of changing professional standards and federal regulations. Several single audit reporting issues that are frequently encountered are discussed in the following pages.

Required Reports. An illustration of the reports required and the source for guidance on each report is provided in exhibit 1.

Reporting on Compliance With Laws and Regulations. Both *Government Auditing Standards* and OMB Circular A-128 require auditors to prepare reports on compliance with laws and regulations. *Government Auditing Standards* requires auditors to prepare a written report on compliance with laws and regulations that may have a material effect on the financial statements. That report is based on the results of procedures performed as part of the audit of financial statements. OMB Circular A-128 requires that, *in addition to* the report required by *Government Auditing Standards,* auditors report on compliance with laws and regulations that may have a material effect on *each major* federal financial

Exhibit 1
Levels of Reporting in Governmental Single Audits



*May be more than one report under SAS No. 63:

- General compliance (SOP 89-6, example 23)
- Major programs (SOP 89-6, examples 18–22)
- Nonmajor programs (SOP 89-6, example 24)

assistance program, as defined by the Single Audit Act, and on compliance with certain laws and regulations applicable to nonmajor federal financial assistance programs. SAS No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance,* provides detailed guidance on these reporting requirements.

Reporting Instances of Noncompliance. Government Auditing Standards requires that the auditor's report on compliance with laws and regulations that may have a material effect on the financial statements include *all material* instances of noncompliance. However, when reporting on compliance with laws and regulations applicable to federal financial assistance programs as required by OMB Circular A-128, *all* instances of noncompliance are to be reported as findings. Materiality is considered, however, in expressing an opinion on compliance with laws and regulations in such audits.

Reporting on Internal Controls. When reporting on internal controls as required by *Government Auditing Standards,* the auditor should include a description of the entity's significant internal control structure policies and procedures categories considered as part of the auditor's understanding of the internal control structure, including the controls established to assure compliance with laws and regulations having a direct and material effect on financial statement line-item amounts.

For reasons of materiality, it may not be appropriate in all circumstances to include a description of the controls related to the general and specific requirements in the report; auditors reporting in accordance with the *Government Auditing Standards* need to consider these controls for inclusion. The decision on whether to include that description should be based on whether noncompliance with a general or specific requirement could result in a material error in the financial statements.

SOP 90-9, *The Auditor's Consideration of the Internal Control Structure Used in Administering Federal Financial Assistance Programs Under the Single Audit Act,* issued in November 1990, provides guidance on the auditor's responsibilities for considering the internal control structure used in administering federal financial assistance programs and reporting on the internal control structure in audits conducted in accordance with the Single Audit Act and OMB Circular A-128. The SOP amends chapter 21 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and supersedes example 26 of SOP 89-6. SOP 90-9 updates the guide and SOP 89-6 to include conclusions set forth in statements on auditing standards that were issued since the guide was originally published.

The SOP is effective for audits performed in accordance with the Single Audit Act for fiscal years beginning on or after January 1, 1991. Earlier application is permitted.

The "50% Rule." The 50% rule described in SOP 90-9 prescribes a minimum requirement for the auditor's consideration of the internal control structure used in administering federal financial assistance programs under the Single Audit Act. The 50% rule stipulates that if major programs constitute less than 50 percent of total federal expenditures, or if there are no major programs, the auditor should perform tests of controls for the largest programs until at least 50 percent of federal financial assistance program expenditures are subject to tests of controls. The rule applies *only* to tests of controls to evaluate the effectiveness of the design and operation of internal control structure policies and procedures relevant to preventing or detecting material noncompliance with specific, general, and certain other requirements. It does not apply to performing substantive tests of compliance with laws and regulations. Nonetheless, the results of tests of controls performed to satisfy the 50% rule should be considered by the auditor in forming a basis for issuing an opinion on compliance with laws and regulations applicable to major federal financial assistance programs, as described in SAS No. 63.

Audit Developments

Proposed Revisions to SAS No. 63

The AICPA Auditing Standards Board has issued an exposure draft of a proposed SAS that would revise SAS No. 63.

Since the issuance of SAS No. 63, certain developments have occurred that affect the guidance provided by that Statement. These developments include the issuance of OMB Circular A-133 and the revision of the OMB *Compliance Supplement for Single Audits of State and Local Governments*. In addition, the Auditing Standards Board became aware of certain issues related to the implementation of SAS No. 63 that require clarification. To address these matters, the Auditing Standards Board has issued a proposed SAS to revise the guidance provided in SAS No. 63.

This proposed Statement would supersede SAS No. 63 and would—

- Provide guidance on the auditor's responsibility when, during an audit in accordance with GAAS, the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement.
- Require the issuance of a report on the general requirements in an audit conducted in accordance with the Single Audit Act and OMB Circular A-128, whether or not the entity has major programs. (SAS No. 63 requires this report only when the entity has major programs.)

- Provide guidance on the auditor's compliance auditing responsibilities under OMB Circular A-133.
- Provide guidance on the auditor's responsibilities when he or she is engaged to conduct a program-specific audit.
- Eliminate from the appendixes certain excerpts of the *Compliance Supplement for Single Audits of State and Local Governments* that have been superseded. (To ensure that they are using up-to-date guidance, practitioners should refer to the appropriate federal sources to obtain the applicable federal requirements.)

Condensed Financial Reporting

Condensed (or summary) financial reporting is becoming a popular reporting method with certain governments. Condensed financial statements present a summary of all or some of the fund types and account groups maintained by the government. A common method is to present the financial statements for an entire government's operations in a single column, usually on the accrual basis of accounting.

Often, the auditor is engaged, or required by professional standards, to report on condensed financial statements (for example, when the condensed financial statements are presented in an auditor-submitted document that contains audited financial statements and the auditor's report thereon). The form and content of the data presented and the nature of the document in which the data are presented generally dictate the reporting guidance to be followed.

Guidance on reporting on condensed financial statements and selected financial data is found in AICPA *Professional Standards,* AU section 551, "Reporting on Information Accompanying the Basic Financial Statements in an Auditor-Submitted Document," and AU section 552, "Reporting on Condensed Financial Statements and Selected Financial Data." Section 551 provides guidance on reporting on condensed financial statements or selected financial data that accompany audited financial statements in an auditor-submitted document. Section 552 provides guidance on reporting in a client-prepared document on condensed financial statements or selected financial data derived from audited financial statements.

Although these AU sections allow certain reporting if condensed financial statements accompany general-purpose financial statements from which they were summarized, current auditing literature requires that an auditor's opinion as to compliance with GAAP be adverse because of inadequate disclosure when condensed financial statements are presented as stand-alone statements.

Additional guidance on reporting on condensed financial statements is being developed by the AICPA's Government Accounting and Auditing Committee.

Accounting Developments

Hierarchy of Generally Accepted Accounting Principles

The AICPA Auditing Standards Board has issued an exposure draft of a proposed statement on auditing standards that would amend AICPA *Professional Standards* AU section 411, "The Meaning of 'Present Fairly in Conformity With Generally Accepted Accounting Principles' in the Independent Auditor's Report," and would create a hierarchy specifically for state and local governments. The amendment would raise AICPA SOPs and audit and accounting guides that have been cleared by the Financial Accounting Standards Board (FASB) or GASB to a level of authority above that of industry practice. Under the new hierarchy, future FASB pronouncements will not apply to state and local governments unless GASB takes positive action to incorporate them into GAAP for state and local governments.

Measurement Focus and Basis of Accounting

The GASB is currently reexamining the basic concepts underlying governmental accounting and financial reporting. A fundamental step in this reexamination process was the issuance of GASB Statement No. 11, *Measurement Focus and Basis of Accounting—Governmental Fund Operating Statements,* which is currently scheduled to be effective for financial statements for periods beginning after June 15, 1994. The extended effective date is necessary to allow adequate time for the GASB to develop, expose, and issue the other recognition, measurement, and financial reporting standards that will be necessary to completely implement the flow-of-financial-resources measurement focus for governmental fund operating statements. This statement will provide guidance for balance sheet reporting of only general long-term capital debt. Guidance for balance sheet reporting of other liabilities arising from or related to the operations of governmental funds will be provided in subsequent GASB statements. As the GASB reexamines other areas of governmental accounting and financial reporting, additional statements will be issued. Early application of the Statement is prohibited.

Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds

GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting,* requires a statement of cash flows (instead of a statement of changes in financial position) as part of a full set of financial statements for all proprietary and nonexpendable trust funds and governmental entities that use proprietary fund accounting. It exempts Public

Employee Retirement Systems (PERSs) and pension trust funds from the requirement to present either a statement of cash flows or a statement of changes in financial position.

This statement requires that a statement of cash flows classify cash receipts and payments according to whether they stem from operating, noncapital financing, capital and related financing, or investing activities, and it provides definitions of each category. Information about investing, capital, and financing activities not resulting in cash receipts or payments in the period is required to be provided separately.

Auditors should clearly distinguish the requirements of FASB Statement No. 95, *Statement of Cash Flows*, from those of GASB Statement No. 9 and follow the appropriate standard.

Major differences between the two statements include the following:

- In GASB Statement No. 9, construction and acquisition of capital assets are not classified as investing as specified in FASB Statement No. 95; instead, they are major elements in a new capital and related financing category.
- The financing category in FASB Statement No. 95 includes cash inflows and outflows related to *both* capital and noncapital borrowing. Capital borrowing activity is another major element in the capital and related financing category.
- To show the complete picture of *all* cash inflows and outflows from financing, acquiring, and disposing of capital assets, it is necessary, under GASB Statement No. 9, to include interest payments in the capital and related financing category rather than in the operating category as required by FASB Statement No. 95. Similarly, under GASB Statement No. 9, interest on noncapital debt is classified as noncapital financing so that it is treated consistently with capital interest and gives a more complete picture of *all* inflows and outflows arising from noncapital debt transactions.
- The nature of investing activity in the governmental environment is focused on the acquisition and disposition of debt and equity instruments of other entities rather than on the investment of ownership capital in capital assets. Therefore, under GASB Statement No. 9, it is more useful to reclassify investment earnings (interest and dividends) as inflows from investing rather than from operating activities. This presents a clearer picture of all the cash flows from investing activities and is consistent with the reclassification of interest expense discussed earlier.

GASB Statement No. 9 is effective for annual financial statements for fiscal years beginning after December 15, 1989. Restatement of financial statements for earlier years provided for comparative purposes is encouraged but not required.

Risk Financing and Related Insurance Issues

GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues,* establishes accounting and financial reporting standards for risk financing and insurance-related activities of state and local governmental entities, including public entity risk pools. The risks of loss that are included within the scope of this statement include torts; theft of, damage to, or destruction of assets; business interruption; errors or omissions; job-related illnesses or injuries to employees; acts of God; and any other risks of loss assumed under a policy or participation contract issued by a public entity risk pool. Also included are risks of loss resulting when an entity agrees to provide accident and health, dental, and other medical benefits to its employees. GASB Statement No. 10 generally requires public entity risk pools to follow the current accounting and financial reporting standards for similar business enterprises, based primarily on FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises.*

The requirements of this statement that affect public entity risk pools are effective for financial statements for periods beginning after June 15, 1990. The requirements for entities other than risk pools are effective for financial statements for periods beginning after June 15, 1994.

Postemployment Benefits Other Than Pension Benefits

GASB Statement No. 12, *Disclosure of Information on Postemployment Benefits Other Than Pension Benefits by State and Local Governmental Employers,* requires that the following disclosures be made by all state and local governmental employers: (1) a description of the benefits provided, employee groups covered, and the employer and participant obligations to contribute; (2) a description of the statutory, contractual, or other authority under which benefit provisions and obligations to contribute are established; (3) a description of the accounting and financing or funding policies followed for those benefits; and (4) the expenditures or expenses for those benefits recognized for the period and certain other related data.

Until the GASB has completed its project on recognition and measurement of postemployment benefits other than pension benefits, state and local governmental employers are not required to change their accounting and financial reporting of those benefits. They are therefore not required to adopt FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* GASB Statement No. 12 is effective for fiscal years beginning after June 15, 1990. Earlier application is encouraged.

Operating Leases

GASB Statement No. 13, *Accounting for Operating Leases With Scheduled Rent Increases,* establishes standards for accounting and financial reporting for operating leases with scheduled rent increases, regardless of the fund type used to report the lease transactions. It requires governmental entities to account for operating leases with scheduled rent increases by using the terms of the lease contract when the pattern of the payment requirements is systematic and rational. This includes lease agreements that specify scheduled rent increases over the lease term that are intended to cover economic factors relating to the property, such as the anticipated effects of cost increases or property value appreciation.

The GASB allows measurement of operating lease transactions using either the straight-line basis or the interest method. FASB Statement No. 13, *Accounting for Leases,* and FASB Technical Bulletin No. 85-3, *Accounting for Operating Leases With Scheduled Rent Increases,* require use of the straight-line basis unless another basis is more representative.

The provisions of GASB Statement No. 13 are effective for leases with terms beginning after June 30, 1990. Retroactive application for leases with terms beginning before July 1, 1990, is permitted.

Reporting Entity

The concept of what constitutes the financial reporting entity of a governmental unit has been evolving and has become more complicated as governments create separate entities to provide regional services, to address debt restrictions, or for other reasons. Some of the entities and arrangements encountered include—

- Entities used to finance certificates of participation.
- Economic development vehicles.
- Joint ventures.
- Entities established to meet legal funding requirements.
- Public authorities.
- Research consortiums with government participation.
- Arrangements that result in contingent liabilities (debt and other).
- Public entity risk pools.

In March 1990 the GASB issued an exposure draft of a statement dealing with this issue. The exposure draft, entitled *The Financial Reporting Entity,* would supersede GASB Codification Section 2100, "Defining the Reporting Entity," and provide additional guidance on this topic. The GASB is analyzing comments received on the exposure draft and expects to issue a final statement in the third quarter of 1991.

Other Developments

Auditor Independence

The AICPA Professional Ethics Division's Executive Committee has revised Ethics Interpretation 101-10, which addresses auditor independence in the government environment. The revised interpretation states that the auditor of a component unit needs to be independent only of that component unit and the oversight entity. The auditor is no longer required to be independent of other component units.

References for Additional Guidance

AICPA

Copies of AICPA publications may be obtained by calling the AICPA Order Department at (800) 334-6961 (except New York) or (800) 248-0445 (New York only).

The following are some publications that will be of interest to auditors of state and local governmental units:

- *Checklists and Illustrative Financial Statements for State and Local Governmental Units (November 1990)* (No. 008502; $20.00, AICPA members $16.80).
- *Financial Report Survey: Illustrations of Compliance Findings in Single Audit Reports of Local Governmental Units* (No. 037989; $21, AICPA members $16.80). This is a survey of reporting under the Single Audit Act of 1984 and OMB Circular No. A-128. It is primarily intended to help auditors of local governmental units prepare a schedule of compliance findings and questioned costs, as required by the Single Audit Act of 1984. This publication presents, by federal agency, more than 100 examples of compliance findings and questioned costs.
- *Local Governmental Accounting Trends and Techniques* (No. 009717; $60.00, AICPA members $48.00). This survey is based on a line-by-line analysis of 500 local governmental reports with fiscal years ending July 1989.

- *Local Governmental Audit and Accounting Manual* (No. 007302; $35.00, AICPA members $28.00). This manual includes sample auditor's reports, a local governmental audit program, disclosure checklists and illustrative financial statements, illustrative internal control structure questions, and a partner's engagement review program for state and local governmental units.

AICPA CPE Courses. The AICPA Governmental Accounting and Auditing Certificate of Educational Achievement program consists of the following series of courses:

- "Governmental Accounting Principles and Financial Reporting" (GAA1)
- "Financial Audits of Governmental Entities" (GAA2)
- "Advanced Governmental Auditing" (GAA3)
- "Auditing Under the Single Audit Act" (GAA4)

On successful completion of the program, the participant is awarded a certificate.

In addition, the AICPA offers the following group-study and self-study courses:

- Group study:
  —"Accounting for Governmental Units Under GASB"
  —"Audits of State and Local Governmental Units"
  —"Audit Requirements of OMB Circular A-133"
  —"Compliance Auditing Under SAS 63"
  —"How to Satisfy Compliance Auditing Requirements of Federal and State Financial Assistance Programs"
  —"Impact of the Single Audit Concept on Your Practice"
  —"Audits of HUD-Assisted Projects"
  —"1988 Yellow Book: *Government Auditing Standards*"
  —"Government Accounting and Auditing Update"
  —"Governmental Performance Auditing"
- Self-study:
  —"Introduction to Governmental Accounting"
  —"Performing a Single Audit"
  —"Audits of State and Local Governmental Units"
  —"Understanding Federal Audit Policies and Procedures"
  —"The 1988 Revised Yellow Book on Government Auditing Standards"

—"Audit Requirements of OMB Circular A-133"
—"Audits of HUD-Assisted Projects"
—"Compliance Auditing Under SAS 63"

Single Audit Information Service

The Single Audit Information Service is a looseleaf reference service offered by the Thompson Publishing Group. It explains how to implement the single audit and provides an update of current events in the governmental audit community. The Single Audit Information Service can be ordered by calling the Thompson Publishing Group at (202) 872-1766.

Federal Agencies—Administrative Regulations

The various federal agencies issue general administrative regulations that apply to their programs. These regulations provide general rules on how to apply for grants and contracts, how grants are made, the general conditions that apply to grantees and contractors, their administrative responsibilities, and the compliance procedures used by the various agencies. These regulations are included in the *Code of Federal Regulations*.

In 1988 a revised OMB Circular A-102, *Grants and Cooperative Agreements With State and Local Governments*, was published, establishing a "common rule" designed to create consistency and uniformity among federal agencies in the administration of grants to and cooperative agreements with state, local, and federally recognized Indian tribal governments. The common rule has been codified in each federal agency's portion of the *Code of Federal Regulations*.

It should also be noted that federal agencies have also codified OMB Circular A-128 in each agency's portion of the *Code of Federal Regulations*. Although the OMB *Compliance Supplement for Single Audits of State and Local Governments* provides the compliance requirements for programs contributing a great majority of funding to state and local governments, federal agencies also develop specific compliance supplements for use in auditing programs not included in the OMB document. These can be obtained directly from the regional office of the appropriate federal agency.

Auditors should also be aware that many agencies have program-specific and other audit requirements that are not covered by Circular A-128. Such requirements may relate to certain programs (such as student financial assistance or HUD-insured mortgage programs), as well as include contract audit requirements.

Federal Agencies—Audit Guides

Federal agencies issue audit guides for various programs and activities. The U.S. Department of Housing and Urban Development (HUD) has issued the following audit guides:

- *Audit Guide for the Use of Independent Public Accountants in Audits of HUD-Approved Nonsupervised Mortgages, Loan Correspondents, and Co-Insuring Mortgagees* (stock number 023-000-00718-5)
- *Audit Guide for the Use of Independent Public Accountants for Audits of Mortgagors Having HUD-Insured or Secretary Held Multifamily Mortgages* (stock number 023-000-00726-6)

These guides are available from the Government Printing Office (GPO), Superintendent of Documents, Washington, DC 20401.

The U.S. Department of Education, Office of the Inspector General, has issued an audit guide, *Audits of Student Financial Assistance Programs* (March 1990). It is available from the Office of the Inspector General, U.S. Department of Education, Washington, DC, and from Offices of Regional Inspectors General for Audit.

General Accounting Office

GAO publications include the following:

- *Government Auditing Standards* (1988 revision) (the "Yellow Book")—The standards relate to audits of government organizations, programs, activities, and functions and of government funds received by contractors, nonprofit organizations, and other nongovernment organizations. The standards incorporate the AICPA Statements on Auditing Standards but prescribe additional standards needed to meet the more varied interests of users of reports on government audits. These standards are available from the GPO, Superintendent of Documents, Washington, DC 20401. The stock number is 020-000-00234-3.
- *Assessing Compliance With Applicable Laws and Regulations*—This booklet, issued by the GAO Office of Policy, is intended to help the auditor implement requirements for detecting noncompliance. Requests for copies of this booklet should be sent to: U.S. General Accounting Office, P.O. Box 6015, Gaithersburg, MD 20877. The telephone number is (202) 275-6241. The number and publication date are GAO/OP-4.1.2 and December 1989, respectively.
- *Assessing the Reliability of Computer-Processed Data*—This guidebook is intended mainly for auditors and evaluators, not for experts in data processing. It provides some guidelines on what

auditors must do to satisfy the standards of the Yellow Book. The Yellow Book requires auditors to satisfy themselves that computer-processed data are relevant and reliable. The number and publication date are GAO/OP-8.1.3 and September 1990, respectively.

- *Assessing Internal Controls in Performance Audits*—This guidebook relates specifically to performance audits. Nonetheless, it is also relevant to audits conducted under the Single Audit Act, which states that auditors must assess compliance with applicable laws and regulations. The number and publication date are GAO/OP-4.1.4 and September 1990, respectively.

Office of Management and Budget—Circulars

The OMB—in consultation with grant-making agencies, the GAO, and representatives of grant recipients—developed a series of financial circulars that establish uniform policies and rules to be observed by all executive branch agencies of the federal government. Circulars and other documents relevant to audits of state and local governmental units are listed below. For copies of circulars, call the Executive Office of the President, Publications Office, at (202) 395-7332; for compliance supplements, call the Government Printing Office at (202) 783-3238.

OMB Circulars Relevant to Audits of State and Local Governments

Circular Number	*Applicability*	*Issue Date*
A-50 (Revised)	Audit follow-up	September 1982
A-73 (Revised)	Audit of federal operations and programs	June 1983
A-87 (Revised)	Cost principles for state and local governments	January 1981
A-102 (Revised)	Grants and cooperative agreements with state and local governments	March 1988
A-128	Audits of state and local governments (see also related questions-and-answers document under "Other OMB Guidance" on p. 26)	April 1985
A-133	Audits of institutions of higher education and other nonprofit institutions	March 1990

Office of Management and Budget—Other Guidance

Other documents issued by the Office of Management and Budget that have accounting and auditing applications are listed below.

- *Catalog of Federal Domestic Assistance*—The *Catalog* is a government-wide compendium of federal programs, projects, services, and activities that provide assistance or benefits to the American public. The General Services Administration (GSA) is responsible for the dissemination of federal domestic assistance information through the *Catalog* and maintains the information data base from which program information is obtained. The OMB serves as an intermediary between other federal agencies and the GSA, thus providing oversight relative to the collection of federal domestic assistance program data.

  Program information provided by the *Catalog* includes authorizing legislation and audit requirements. The GSA distributes copies to certain specified national, state, and local government offices. *Catalog* staff may be contacted at (202) 708-5126. Individuals must write the GPO, Superintendent of Documents, Washington, DC 20401, or call (202) 783-3238.

  Program information is also available on machine-readable magnetic tape. The tape may be purchased by writing the Federal Domestic Assistance Catalog Staff, General Services Administration, Ground Floor, Reporters Building, 300 7th Street, S.W., Washington, DC 20407, or calling (202) 708-5126.

- *Compliance Supplement for Single Audits of State and Local Governments*—The *Compliance Supplement* sets forth the major federal compliance requirements that should be considered in a single audit of state and local governments that receive federal assistance. It supplements OMB Circular A-128. The latest revision, which includes the three new general requirements, was issued in September, 1990. Information regarding the *Compliance Supplement* may be obtained by contacting the OMB Financial Systems and Policy Branch at (202) 395-3993.

- *Questions and Answers on the Single Audit Provisions of OMB Circular A-128, Audits of State and Local Governments*—This document provides guidance relative to the single audit process through a series of questions and answers. The document is available from the Executive Office of the President, Publications Office, at (202) 395-7332.

- *Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments (Common Rule)*—This document, as revised and adopted by the various federal agencies, is available by reference to the *Federal Register,* vol. 53, no. 48 (March 11, 1988).

PCIE Subcommittee Guidance

The PCIE Standards Subcommittee publishes supplemental, nonauthoritative guidance for federal officials dealing with issues arising from the implementation of the Single Audit Act; OMB Circular A-128, which implements the act; and OMB Circular A-133, which extends the single audit concept to institutions of higher education and other nonprofit institutions.

The PCIE Standards Subcommittee has issued the following position statements:

- PCIE Statement No. 1 provides guidance on determining when a series of audits of individual federal departments, agencies, and establishments may be considered an audit for purposes of the Single Audit Act.
- PCIE Statement No. 2 provides guidance to cognizant agencies on determining whether an audit report that does not meet the 50% rule on internal control coverage prescribed in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* should be accepted.
- PCIE Statement No. 3 provides guidance on using a cyclical approach to internal control reviews of nonmajor programs.
- PCIE Statement No. 4 establishes uniform procedures for referrals of substandard audits to state boards of accountancy and the AICPA.
- PCIE Statement No. 5 provides guidance for certain not-for-profit entities other than institutions of higher education or hospitals not covered by OMB Circular A-110, *Uniform Administrative Requirement for Grants and Other Agreements With Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations.*

These are available together in one document (stock number PCIE-06-058).

The PCIE also issues the following checklists for desk and quality control reviews:

- *Uniform Desk Review Guide of A-128 Single Audits* (stock number PCIE-06-057)
- *Uniform Quality Control Review Guides for A-128 Single Audits* (stock number PCIE-06-058)

Copies of PCIE publications may be obtained by writing the Treasury Office of the Inspector General, Room 7210, ICC Building, 1201 Constitution Ave., N.W., Washington, DC 20220.

Government Finance Officers Association

The GFOA's address and telephone number are 180 N. Michigan Avenue, Suite 800, Chicago, IL 60601-7476; (312) 977-9700. Its publications include the following:

- *Governmental Accounting, Auditing, and Financial Reporting (GAAFR)*—The GAAFR provides nonauthoritative guidance, and includes implementation guidance, on the practical application of GAAP for governments. The GAAFR also includes implementation guidance on the many pronouncements of the GASB, detailed journal entries and explanations that cover a multitude of common and complex transactions, a complete sample comprehensive annual financial report, discussion and illustration of single audit requirements, a glossary and chart of accounts, and a detailed index. (The *GAAFR Study Guide* is also available.)
- *Audit Management Handbook*—This handbook on audit management is intended for state and local governments and CPA firms that are involved in obtaining or performing financial audits. It provides information on all aspects of the audit management process, including establishing the scope of the audit, audit procurement (including model requests for proposal), monitoring the audit, and resolving audit issues and findings.
- *Financial Reporting Series*—This set of books contains information and examples of how governments present specific financial reporting information. It includes—
    1. *Illustrations of Notes to the Financial Statements of State and Local Governments.*
    2. *Illustrations of Introductory Sections of Comprehensive Annual Financial Reports of State and Local Governments.*
    3. *Illustrations of Statistical Sections of Comprehensive Annual Financial Reports of State and Local Governments.*
    4. *Illustrations of Supplementary Financial Data in Comprehensive Annual Financial Reports of State and Local Governments.*
    5. *Illustrations of Interim Financial Statements of State and Local Governments.*
    6. *How to Understand Local Government Financial Statements: A User's Guide.*
    7. *Illustrations of Combined, Combining, and Individual Fund and Account Group Financial Statements of State and Local Governments.*
    8. *Suggested Solutions to Governmental Accounting and Financial Reporting Practice Problems in Applying Authoritative Standards.*
    9. *Illustrations of Popular Reports of State and Local Governments.*

10. *A Public Manager's Guide to Government Accounting and Financial Reporting.*

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Copies of AICPA authoritative guidance may be obtained by calling the AICPA Order Department at (800) 334–6961 (USA) or (800) 248–0445 (NY). Copies of FASB authoritative guidance may be obtained directly from the FASB by calling the FASB Order Department at (203) 847–0700, ext. 10. Copies of GASB publications may be obtained by calling the GASB Order Department at (203) 847-0700, extension 10.

Audit Risk Alert—1990*

General Update on Economic, Industry, Regulatory, and Accounting and Auditing Matters

Introduction

This alert is intended to help auditors in finalizing their planning for 1990 year-end audits. Successful audits are a result of a number of factors, including acceptance of clients with integrity, adequate partner involvement in planning and performing audits, an appropriate level of professional skepticism, and the allocation of sufficient audit resources to high-risk areas. Addressing these factors in each audit engagement requires substantial professional judgment based, in part, on a knowledge of professional standards and current developments in business and government.

It is important to make sure that written audit programs are *adequately tailored* to reflect *each client's circumstances,* including areas of greater *audit risk.* This alert identifies areas that, based on current information and trends, may be relevant to many 1990 year-end audits. Although it does not provide a complete list of risk factors to be considered, and the items discussed do not affect risk in every audit, this alert can be used as a planning tool for considering matters that may be especially significant for 1990 audits.

Economic Developments

The Current Economic Downturn

Dramatic events in the Persian Gulf and around the world have raised many questions and concerns for American companies. Rising oil prices, lower consumer demand, and reduced availability of capital are just *some* of the factors affecting companies in all industries. Auditors should take these economic factors into consideration and be aware of the ways in which clients have been affected by them as well as of the potential, if any, of a going-concern problem.

*This Audit Risk Alert was published in the December 1990 issue of the AICPA's *CPA Letter.*

Business Failures on the Rise

The current illiquidity in the junk-bond market, coupled with the continuing tightening of credit by lenders throughout the country, have made it substantially more difficult for prospective borrowers to obtain financing, particularly for highly leveraged companies. A recent article in the *Wall Street Journal* called attention to increases in bankruptcy filings, particularly in the real estate, apparel, retailing, and construction industries, due in large part to the weakening cash flow of many businesses as well as the more cautious credit environment. Some industries are becoming very risky undertakings. For example, in 1990, the number of restaurant closings exceeded the number of openings; increased competition has made it nearly impossible to raise menu prices, while costs have continued to increase, especially those for energy, insurance, and wages.

The effects of the economic slowdown will vary across geographic regions and industries, and among companies even within the same industry. Therefore, auditors need to focus specifically on the environment of each client and address each client's particular issues accordingly. Nevertheless, many companies will be unable to pass on increased costs (particularly increased oil prices and medical expenses) due, in part, to increasing competition and softening demand for their products. This could make it difficult for companies to report favorable operating results for the year. With this in mind, auditors should be even more sensitive this year to ongoing issues that affect operating results, such as the collectibility of receivables and the potential obsolescence and realizability of inventories.

Highly leveraged companies are particularly vulnerable to a downturn in business activity and the other factors discussed above. Auditors should consider these circumstances when evaluating the ability of highly leveraged clients to continue as going concerns.

Economic Considerations Relating to Debt

Adverse developments in the economy in general, or in a particular financial institution, may cause an institution to refuse to renew loans, to exercise demand clauses (such as the due-on-demand clause), or to decline to waive covenant violations. In addition, these developments may make it more difficult for companies to obtain alternate sources of financing than in the past. In these cases, the auditor should consider the borrower's classification of the liability, potential going-concern issues, management's plans (such as those for alternate financing or asset disposition), and the adequacy of disclosures in the borrower's financial statements. Securities and Exchange Commission (SEC) rules contain specific disclosure requirements in Management's Discussion and Analysis (MD & A) about liquidity and material uncertainties.

Regulatory and Legislative Developments

Environmental Liabilities

The Environmental Protection Agency is empowered by law (through the Superfund legislation) to seek recovery from anyone who ever owned or operated a particular contaminated site, or anyone who ever generated or transported hazardous materials to a site (these parties are commonly referred to as potentially responsible parties, or PRPs). Potentially, the liability can extend to subsequent owners or to the parent company of a PRP.

In connection with audit planning, the auditor should consider making inquiries of management about whether a client (or any of its subsidiaries) has been designated as a PRP or otherwise has a high risk of exposure to environmental liabilities. If a client has been designated as a PRP, the auditor should consider whether any amount should be accrued for cleanup costs and assess the need for disclosure and, possibly, for the inclusion of an explanatory fourth paragraph in the audit report citing the uncertainty, if management is unable to make reasonable estimates of the costs. In addition, for public entities, disclosure should be made in MD&A of estimates of cleanup costs or the reasons why the matter will not have a material effect.

Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*, and Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, provide guidance for the accounting and disclosure of loss contingencies, including those related to environmental issues. The FASB's Emerging Issues Task Force (EITF) reached a consensus in Issue 90-8, *Capitalization of Costs to Treat Environmental Contamination*, that, generally, the costs incurred to treat environmental contamination should be expensed and may be capitalized only if specific criteria are met.

Notification of Termination of Auditor-Client Relationship

The SEC staff has observed instances in which CPA firms have not notified the SEC's Chief Accountant when an auditor-client relationship ends. Under a rule effective May 1, 1989, member firms of the SEC Practice Section of the AICPA Division for Firms must notify the SEC directly by letter *within five business days* after the auditor resigns, declines to stand for reelection, or is dismissed.

New Auditing Pronouncements

Implementing SAS No. 55 on Internal Control

AICPA Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, is effective for audit periods beginning on or after January 1, 1990. Auditors who did not apply its provisions early are faced with implementation for December 31, 1990, year-end audits.

To help auditors with questions that may arise, the Auditing Standards Board (ASB) issued the Audit Guide *Consideration of the Internal Control Structure in a Financial Statement Audit*. The guide presents two preliminary audit strategies for assessing control risk and uses three hypothetical companies ranging from a small, owner-managed business to a large public company to illustrate how the strategies affect the nature, timing, and extent of procedures. Particularly helpful is a series of exhibits that includes sample workpapers documenting the hypothetical companies' compliance with SAS No. 55. A copy of the guide (product number 012450) may be obtained by calling the AICPA Order Department at (800) 334-6961 (USA) or at (800) 248-0445 (NY).

New Financial Institutions Confirmation Form

The AICPA will replace the existing 1966 Standard Bank Confirmation Inquiry. The new form will provide only confirmation of *deposit* and *loan* balances. To confirm other transactions and arrangements, auditors will have to send a separate letter, signed by the client, to a financial institution official responsible for the financial institution's relationship with the client or knowledgeable about the transactions or arrangements. Anyone ordering the new standard form from the AICPA Order Department will receive a copy of a notice to practitioners, which describes the revisions to the process of confirming information with financial institutions, and illustrative letters for confirming some of these types of transactions or arrangements. The new form should be used for confirmations mailed on or after March 31, 1991. Practitioners should neither use the new form before March 31, 1991, nor use the old form on or after that date.

New SAS on Internal Auditing

In January 1991, the ASB will issue a new SAS, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, that will provide practitioners with expanded guidance when considering the work of internal auditors. Many internal audit activities are relevant to an audit of financial statements because they provide evidence about the design and effectiveness of internal control structure policies and procedures or provide direct evidence about misstatements of financial data contained in financial statements. The SAS is effective for audits of financial statements for periods beginning on or after January 1, 1991, and will include guidance to assist auditors in obtaining an understanding of the internal audit function, assessing the competence and objectivity of internal auditors, and determining the extent to which they may consider work performed by internal auditors. The SAS supersedes SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Audit*, and incorporates the terminology and concepts of more recent SASs, particularly SAS No. 55.

Forthcoming Guidance on Circular A–133

On March 8, 1990, the Office of Management and Budget (OMB) issued Circular A–133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*. The purpose of Circular A–133 is to establish audit requirements and to define federal responsibilities for implementing and monitoring audit requirements for institutions of higher education and other nonprofit institutions receiving federal awards. Institutions covered by Circular A–133 generally include colleges and universities (and their affiliated hospitals) and other not-for-profit organizations, such as voluntary health and welfare organizations and other civic organizations.

The circular applies to nonprofit institutions that receive $100,000 or more in federal awards. (Circular A–133's definition of *financial awards* is broader than the term *financial assistance* used in SAS No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*.) Nonprofit institutions that receive at least $25,000 but less than $100,000 in federal financial assistance have the option of applying either the requirements of Circular A–133 or separate program audit requirements. For institutions receiving less than $25,000, records must be kept and made available for review, if requested, but the provisions of the circular do not apply.

In the first quarter of 1991, the AICPA's Auditing Standards Division plans to expose a statement of position, prepared by a subcommittee of the AICPA Not-for-Profit Organizations Committee, that will provide guidance about compliance-auditing requirements in Circular A–133. Circular A–133 is effective for audits of fiscal years beginning on or after January 1, 1990. Since the circular permits biennial audits, some institutions may not be required to follow its requirements until the audit of their financial statements for the fiscal year ending June 30, 1992.

Audit Reporting and Communication Issues

Reporting on Uncertainties

Some auditors have issued an unqualified report with an additional paragraph about the existence of an uncertainty in situations when a qualified or adverse opinion should have been issued.

SAS No. 58, *Reports on Audited Financial Statements,* requires an auditor to add an explanatory paragraph (after the opinion paragraph) to the standard report when a matter is expected to be resolved at some future date, at which time sufficient evidence about its outcome is likely to be available. Examples of such uncertainties include lawsuits against the entity and tax claims by tax authorities when precedents are not clear. Because its resolution is prospective, sometimes management cannot estimate the effect of the uncertainty on the entity's financial statements. However, those uncertainties have, in some cases, been confused with other situations in which management asserts that it is unable to estimate certain financial statement elements, accounts, or items.

Generally, matters whose outcomes depend on the actions of management and relate to typical business operations are susceptible to reasonable estimation and, therefore, are estimates inherent in the accounting process, not uncertainties. Management's inability to estimate in these situations should raise concerns about the possible use of inappropriate accounting principles or scope limitations. If the auditor believes that financial statements are materially misstated because of the use of inappropriate accounting principles, a qualified or adverse opinion is required due to the GAAP departure. A scope limitation should result in a qualified opinion or a disclaimer of opinion.

Going-Concern Matters

When an auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern, SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* requires the auditor to include an explanatory paragraph (following the opinion paragraph) in the report to reflect that conclusion. Auditors have issued reports in which it is unclear whether they are expressing a conclusion that there is substantial doubt about an entity's ability to continue as a going concern.

For situations in which the auditor expresses such a conclusion, the ASB recently amended SAS No. 59 to require the use of the phrase "substantial doubt about the entity's ability to continue as a going concern" (or similar wording that includes the terms *substantial doubt* and *going concern*) in the required explanatory paragraph.

Required Communications to Audit Committees and Others Having Oversight Responsibility

Instances have been noted in which auditors have overlooked the communication requirements of SAS No. 61, *Communication With Audit Committees*. This statement requires auditors to ensure that certain matters are communicated to audit committees or other groups with responsibility for oversight of the financial reporting process. SAS No. 61 applies to—

- Entities that have an audit committee or a formally designated group having oversight responsibility for financial reporting (for example, a finance or budget committee).
- All SEC engagements as defined in note 1 of the statement.

In considering the communications required by SAS No. 61, the auditor should also not overlook the communications required by the following:

- SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*
- SAS No. 54, *Illegal Acts by Clients* (see discussion below)
- SAS No. 60, *Communications of Internal Control Structure Related Matters Noted in an Audit*

Illegal Acts

SAS No. 54 provides guidance for communications with clients of possible illegal acts. The auditor has a responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on financial statement line-item amounts. Auditors may also become aware of other illegal acts that have, or are likely to have, occurred and that may not have a direct and material effect on financial statement amounts.

Auditors should assure themselves that all illegal acts that have come to their attention, unless clearly inconsequential, have been communicated to the audit committee or its equivalent (the board of trustees or an owner-manager) in accordance with SAS No. 54.

Recurring Audit Problems

Questionable Accounting Practices

Managements of companies—public or private—might feel pressure to report favorable results—for example, to maintain a trend of growth in earnings, support or improve the price of the company's stock, obtain or maintain essential financing, or comply with debt covenants. This pressure is most likely to affect public companies, but auditors should not underestimate the pressures on nonpublic companies to "stretch" earnings or report a favorable financial condition—particularly in light of the current credit crunch. In most cases, the actions taken are well-intentioned and believed to be appropriate by the company. However, in certain cases, the result is an inappropriate accounting practice.

The downturn in the economy may have an effect on the way a client conducts its business and carries out its revenue recognition policies. Auditors should be alert to facts and circumstances relating to revenue recognition policies that may not be appropriate, such as—

- Changes in standard sales contracts permitting, for example, continuation of cancellation privileges.
- Situations in which the seller has significant continuing involvement or the buyer has not made a sufficient financial commitment to demonstrate an intent or ability to pay.
- Certain sales with a "bill and hold" agreement.

Revenue should not be recorded until it is realized or clearly realizable, the earnings process is complete, and its collection is reasonably assured.

The following are some other accounting practices that distort operating results or financial position:

- Improperly deferring typical period costs and expenses (for example, personnel, training, and moving costs) or costs for which a specific quantifiable future benefit has not been determined
- Adjusting reserves without adequate support
- Nonaccrual of losses (for example, environmental liabilities) or inadequate disclosure in accordance with FASB Statement No. 5, *Accounting for Contingencies*
- Inadequate recognition of uninsured losses (for example, increased deductibles for workers' compensation or medical care)
- Using improper LIFO accounting practices, including inappropriate pools and intercompany transactions

Competent and sufficient audit evidence continues to be the foundation for the auditor's opinion. Insufficient professional skepticism, illustrated by "auditing by conversation," or failing to obtain solid evidence to back up management's representations, can lead to audit problems. In the final analysis, auditors need to step back and ask one of auditing's most fundamental questions: Does it make sense?

Problems also can occur due to errors in recording relatively straightforward transactions, particularly in those situations where cost-reduction and restructuring programs have reduced the number and quality of accounting personnel. The importance of principal audit procedures (for example, sales and inventory cut-off tests, searches for unrecorded liabilities, and follow-up on errors noted during tests) cannot be overemphasized. These types of procedures are fundamental and critical to the audit process.

Although clients may impose fee pressures or tight deadlines on auditors, these pressures do not change the professional responsibility to understand and audit the facts and situations carefully and to make professional, knowledgeable decisions.

Communications Between Predecessor and Successor Auditors

SAS No. 7, *Communications Between Predecessor and Successor Auditors,* establishes requirements for communications between predecessor and successor auditors when a change of auditors has taken place or is in process. It has been observed that the guidance provided by SAS No. 7 is sometimes not followed. It is essential that both predecessor and successor auditors are aware of, and adhere to, the requirements of SAS No. 7. For example, the predecessor auditor should respond promptly and fully to the successor's reasonable inquiries unless he or she indicates that the response is limited.

Part of Audit Performed by Other Independent Auditors

In accordance with SAS No. 1 (AICPA, *Professional Standards,* vol. 1, AU sec. 543), in no circumstances should an auditor state or imply that an audit report making reference to another auditor is inferior in professional standing to a report without such a reference. When a principal auditor decides not to make reference to the work of another auditor, the extent of additional procedures to be performed by the principal auditor may be affected by the other auditor's quality-control policies and procedures (see auditing interpretation "Part of Audit Performed by Other Auditors: Auditing Interpretations of AU Section 543" [AICPA, *Professional Standards,* vol. 1, AU sec. 9543.18]).

Attorney's Responses

A letter of audit inquiry to the client's lawyer is the auditor's primary means of corroborating information furnished by management concerning litigation, claims, and assessments. Auditors should carefully read all letters from attorneys and ensure that all matters discussed are understood. Ambiguous and incomplete responses should be appropriately resolved with client management and attorneys, and conclusions should be properly documented. An auditing interpretation of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments,* presented in the AICPA's *Professional Standards,* vol. 1, AU sec. 9337.18, discusses what constitutes an acceptable reply. Additional inquiries may be needed if replies are not dated sufficiently close to the date of the audit report.

Pitfalls for Auditors

Each year-end seems to abound with pitfalls for auditors. The following reminders are intended to alert auditors to some of these pitfalls.

- Watch out for large, unusual, one-time transactions, especially at or near year-end, that may be designed to ease short-term profit and cash flow pressures. Scrutinize each transaction to ensure validity of business purpose, timing of revenue or profit recognition, and adequacy of disclosure.
- In performing analytical procedures (for example, analyzing accounts, changes from period to period, and differences from expectations), maintain an attitude of objectivity and professional skepticism. Do not assume that the accounts or client explanations are right. Rather, question, challenge, and compare new information with what is already known about the client and of business in general.
- Make sure that receivables that are supported by real estate as collateral reflect the softening of the market. Increases in the allowance for uncollectibles may be needed. Recognize that assets acquired through foreclosure may be overvalued and difficult to sell.
- Pay special attention to the collectibility of significant receivables from debtors that have recently gone through a leveraged buyout (LBO). A company is not the same entity that it was before an LBO.

Accounting Developments

Financial Instruments Disclosure

In March 1990, the FASB issued Statement No. 105, *Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* effective for fiscal years ending after June 25, 1990. It applies to all entities, including small businesses (due to its requirement to disclose significant concentrations of credit risk arising from all financial instruments, including trade accounts receivable).

The statement applies to all financial instruments with off-balance-sheet risk of accounting loss and all financial instruments with concentrations of credit risk, with some exceptions that are detailed in paragraphs 14 and 15 of the statement. It requires all entities with financial instruments that have off-balance-sheet risk to disclose the face, contract, or underlying principal involved; the nature and terms of the financial instrument; the accounting loss that could occur; and the entity's policy regarding collateral or other security and a description of the collateral.

Postretirement Benefits Other Than Pensions

The FASB is expected to issue the final statement on postretirement benefits other than pensions in December 1990. The proposed statement would significantly change the prevalent current practice of accounting for postretirement benefits on the "pay as you go" (cash) basis by requiring accrual, during the years that employees render services, of the expected cost of providing those benefits to employees and their beneficiaries and covered dependents. This statement would be effective for calendar-year 1993 financial statements. An additional two-year delay would be provided for plans of non-U.S. companies and certain small employers.

In the SEC Staff Accounting Bulletin (SAB) No. 74, *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period,* the SEC staff expressed its belief that disclosure of *impending* accounting changes is necessary to inform readers about expected effects on financial information to be reported in the future and should be made in accordance with existing MD&A requirements. The SEC staff provided supplemental guidance regarding SAB No. 74 in the November 1990 EITF minutes.

Reporting When in Bankruptcy

Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code,* provides guidance for entities that have filed petitions with the Bankruptcy Court and expect to reorganize as going concerns under Chapter 11.

The SOP recommends that all such entities report the same way while reorganizing under Chapter 11, with the objective of reflecting their financial evolution. To do that, their financial statements should distinguish transactions and events that are directly associated with the reorganization from the operations of the ongoing business as it evolves.

The SOP generally becomes effective for financial statements of enterprises that have filed petitions under the Bankruptcy Code after December 31, 1990.

Audit Risk Alerts

The Auditing Standards Division is issuing Audit Risk Alerts to advise auditors of current economic, industry, regulatory, and professional developments that they should be aware of as they perform year-end audits. The following industries are covered:

- Airlines (022071)
- Agricultural producers and agricultural cooperatives (022073)
- Banking (022063)
- Casinos (022070)
- Construction contractors (022066)
- Credit unions (022061)
- Employee benefit plans (022055)
- Federal government contractors (022068)
- Finance companies (022060)
- Investment companies (022059)
- Life and health insurance companies (022058)
- Nonprofit organizations, including colleges and universities and voluntary health and welfare organizations (expected to be available in March 1991) (022074)
- Oil and gas producers (022069)
- Property and liability insurance companies (022072)
- Providers of health care services (022067)
- Savings and loan institutions (022076)
- Securities (022062)
- State and local governmental units (022056)

Copies of these industry updates may be purchased from the AICPA Order Department. They will also be included in the new loose-leaf service for audit and accounting guides.

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